MOTION FILED
JUN 13 1994

No. 93-823

(12)

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,
Petitioner,

v.

JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of Nebraska

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE AND BRIEF OF THE DREYFUS CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

Pursuant to Rule 37.4 of the Rules of this Court, The Dreyfus Corporation ("Dreyfus") respectfully moves this Court for leave to file the attached brief as *amicus curiae* in this case. Counsel for the petitioner has consented to the filing of this brief, but counsel for the respondent has declined to consent. Copies of the respective responses to Dreyfus' request for consent have been filed with the Clerk of the Court.

The Dreyfus Corporation ("Dreyfus") is one of the largest mutual fund organizations in the United States, currently managing or administering more than $70 bil-

lion in assets for over 1.9 million mutual fund accounts nationwide. In providing investment management services to various mutual funds and closed-end investment companies (collectively known as "funds"), Dreyfus considers repurchase agreements and reverse repurchase agreements (collectively known as "repos") to be safe temporary investment vehicles for funds structured to pay dividends not exempt from federal income tax (herein referred to as "taxable funds"). To further ensure the safety of such taxable fund assets, the securities underlying repos consist entirely of direct obligations of the United States Treasury or other obligations specifically exempt from taxation by any state or political subdivision (collectively referred to as "federal obligations").*

Dreyfus is strongly interested in this Court's interpretation of the prohibition against direct and indirect taxation of federal obligations accorded by 31 U.S.C. Section 3124(a) and its related predecessor statutes. In this regard, Dreyfus believes that the federal prohibition against indirect state taxation accorded to shareholders of taxable funds under 31 U.S.C. Section 3124(a) should extend not only to fund dividends derived from interest on federal obligations, but also to income derived from repos to the extent such income is derived from interest on federal obligations. Because this decision could have significant ramifications on Dreyfus' investment policies as well as its taxable fund shareholders, Dreyfus has a strong interest in the outcome of this case.

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* *See, e.g.*, 12 U.S.C. Section 1433 (securities issued by the Federal Home Loan Banks); 12 U.S.C. Section 1441a(g) (obligations issued by the Resolution Trust Corporation); 12 U.S.C. Section 1725(e) (obligations issued by the Federal Savings and Loan Insurance Corporation); 12 U.S.C. Section 1825 (obligations issued by the Federal Deposit Insurance Corporation); 12 U.S.C. Section 2023 (obligations issued by Federal Farm Credit Banks); 12 U.S.C. Section 2290 (obligations issued by the Federal Financing Bank); 20 U.S.C. Section 1087-2(1) (obligations issued by Student Loan Marketing Association); and 31 U.S.C. Section 3124(a) (obligations of the United States Treasury, including, but not limited to, United States Treasury bonds, bills and notes).

Respectfully submitted,

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JUNE 1994

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BRIEF FOR THE DREYFUS CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

INTEREST OF THE AMICUS CURIAE

The interest of the amicus curiae is set forth in the motion accompanying this brief.

SUMMARY OF ARGUMENT

Federal law contains a broad prohibition against direct and indirect state taxation imposed on federal obligations. It is well settled that this immunity flows through a mutual fund to its shareholders. Dividends paid to mutual fund shareholders that are derived from the mutual fund's ownership of federal obligations are immune from state taxation.

The same conclusion should apply when such dividends are derived from repurchase agreements or reverse repurchase agreements (collectively known as "repos") involv-

ing federal obligations. In that setting state taxation of the income in the hands of the shareholders will affect the investment attractiveness of federal securities, thereby increasing the federal government's cost of borrowing. Although repos have been treated in different contexts either as purchases and sales or as secured loans, the dominant view is that they are purchases and sales in which a repo investor (in this case, the mutual fund) actually earns interest on the federal obligation. Moreover, even in settings where the transactions are treated as secured loans, the law recognizes the existence of the underlying federal obligation and treats the transaction accordingly. Thus, it is appropriate to extend the immunity of 31 U.S.C. Section 3124 to income earned from repo transactions involving federal obligations.

ARGUMENT

STATE TAXATION OF DIVIDENDS EARNED BY MUTUAL FUND SHAREHOLDERS DERIVED FROM FUND INVESTMENTS IN REVERSE REPURCHASE AGREEMENTS INVOLVING FEDERAL OBLIGATIONS WOULD VIOLATE 31 U.S.C. SECTION 3124(a)

A. 31 U.S.C. Section 3124(a) broadly prohibits both direct and indirect state taxation of interest on federal obligations.

The prohibition against state and local taxation of federal obligations and the interest thereon is derived from the Supremacy and Borrowing Clauses of the United States Constitution, Article VI, Clause 2, and Article I, Section 8, respectively. The immunity of the federal government from state taxation was first articulated in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1816). This Court has explained the constitutional principles underlying the immunity as follows:

> It is elementary that the bonds or other securities of the United States may not be taxed by state authority. That immunity always has been deemed an attribute of national supremacy and essential to its maintenance. The power of Congress to borrow money on the Credit of the United States would be burdened and might be destroyed by state taxation of the means employed for that purpose. As the tax-exempt feature tends to increase and is reflected in the market prices of such securities, a state tax burden thereon would adversely affect the terms upon which money may be borrowed to execute the purposes of the general government. . . . Neither ingenuity in calculation nor form of words in state enactments can deprive the owner of the tax exemption established for the benefit of the United States.

Missouri ex rel. Missouri Ins. Co. v. Gehner, 281 U.S. 313, 320-321 (1930).

In 1862, Congress embodied this immunity in a statute, which provided that: "(a)ll stocks, bonds, and other securities of the United States held by individuals, corporations, or associations, within the United States, shall be exempt from taxation by or under State authority."[1] Congress revised the federal statute in 1876, enacting Rev. Stat. Section 3701, 31 U.S.C. Section 742, which changed the language of the 1862 immunity provision to read simply "(a)ll stocks, bonds, Treasury notes and other obligations of the United States, shall be exempted from taxation by or under State or municipal or local authority." Although the statute prevented imposition of tax on federal obligations held directly, the statute was construed to allow state taxation of a stockholder's interests in a corporation even if the corporation's assets consisted, all or in part, of federal obligations.[2] The theory was that stock ownership represents a separate property interest from the underlying assets of a corporation.[3]

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[1] Act of Feb. 25, 1862, ch. 33, Section 2, 12 Stat. 346.

[2] *See Des Moines National Bank v. Fairweather*, 263 U.S. 103 (1923); *Cleveland Trust Co. v. Lander*, 184 U.S. 111 (1902); and *Van Allen v. Assessors*, 70 U.S. (3 Wall.) 573 (1866).

[3] *See Society for Savings v. Bowers*, 349 U.S. 143, 147-148 (1955).

In 1959, Congress modified 31 U.S.C. Section 742 by adding the following sentence to the statute:

> This exemption extends to every form of taxation that would require that either the obligations or other interest thereon, or both, be considered, *directly or indirectly, in the computation of the tax*, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate and inheritance taxes.

Pub. L. No. 86-346, Section 105(a), 73 Stat. 622 (1959) (emphasis added). In its first decision construing the amended statute, this Court characterized the new exemption created by the amendment as "sweeping" and, under its plain language, constituting a prohibition of state taxation, regardless of its form, if federal obligations must be considered, either directly or indirectly, in computing the tax. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

In *American Bank*, this Court invalidated a Texas property tax imposed on bank shareholders because the tax failed to provide a deduction for the value of federal obligations held by the bank in the calculation of the value of the bank stock. This Court explained how the amendment broadened the scope of the statutory immunity:

> the amendment abolished the formalistic inquiry whether the tax is on a distinct interest, and replaced it with the inquiry whether "computation of tax" requires consideration of federal obligations.
>
> . . .
>
> Congress understood the amendment's effect; both the Senate and the House Reports explained that the amendment "makes it clear that both the principal and interest on U.S. obligations are exempt from *all State taxes* except nondiscriminatory franchise, etc., taxes."

Id. at 867 (emphasis and quotation marks in original; citations omitted).

In 1982, the prohibition imposed by 31 U.S.C. Section 742 was transferred to 31 U.S.C. Section 3124(a), and the language was simplified. The words "directly and indirectly" were "omitted as surplus." *See* H.R. Rep. No. 651, 97th Cong., 2d Sess., *reprinted in* 1982 U.S.C.C.A.N. 1895, 1988-89. The House Report emphasized that "(t)he purpose of the bill is to restate in comprehensive form, without substantive change, certain general and permanent laws related to money and finance and to enact those laws as title 31, United States Code." *Id.* at 1895. In addressing a perceived fear that changes in language would be deemed changes in the substantive law, the House Report notes:

> (t)his fear might have some weight if this were the usual kind of amendatory legislation where it can be inferred that a change of language is intended to change substance. In a codification law, however, the courts uphold the contrary presumption: the law is intended to remain substantively unchanged.

Id. at 1897 (citations omitted). This Court has recognized that the 1982 legislative reformulation of the federal statute was made without substantive change. *See First National Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583, 585 n.1 (1985).

In summary, the history behind the amendments leading up to the current language in 31 U.S.C. Section 3124(a) evidences Congress' intent to prevent states from using any scheme of taxation, other than those expressly allowed, that would directly or indirectly include the value of or income from federal obligations in the measure of a state tax. In addition, this Court has acknowledged the strong policy basis for this immunity—namely, that state taxation of federal obligations, directly or indirectly, impacts the market value and investment attractiveness of such obligations. *See Smith v. Davis*, 323 U.S. 111, 117

(1944); and *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929).

B. The prohibitions of 31 U.S.C. Section 3124(a) are fully applicable to dividends paid to mutual fund shareholders derived from interest on federal obligations.

The respondent in this case earned dividend income attributable to a fund's investment in certain repurchase agreements and reverse repurchase agreements (collectively referred to as "repos"). The underlying assets of the repos were federal obligations. In *Burks v. Lasker*, 441 U.S. 471 (1979), in the context of a derivative action by a mutual fund shareholder, this Court viewed a mutual fund to be a "pool of assets, consisting primarily of portfolio securities, *and belonging to the individual holding shares in the fund*." *Id.* at 480 (emphasis added). *See also Tannenbaum v. Zeller*, 552 F.2d 402, 405 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977). In addition, it is well settled that a shareholder of a mutual fund (also known as open-end investment company) or closed-end investment company (collectively referred to as a "fund"), qualifying as a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986 (26 U.S.C.), as amended (the "Code"), is effectively taxed as if he or she earned income from holding the assets of the fund directly.[4] In

[4] A fund must effectively distribute, on a current basis, all of its taxable income by the end of each year to avoid the imposition of entity-level taxation. Sections 852 and 4982(a) of the Code. *Cf.* Sections 702(a) and 704(a); and *United States v. Basye*, 410 U.S. 441 (1973), where this Court stated that "it is axiomatic that each partner must pay taxes on his distributive share of . . . [a] . . . partnership's taxable income, without regard to whether that amount is actually distributed to him." Absent unreasonably accumulating earnings, as defined under Section 532, most other corporate entities do not have a similar current distribution requirement. *But see*, e.g., Section 857(a)(1), as applied to real estate investment trusts, and Section 1366(a), as applied to S corporations.

this respect, fund dividends differ from other corporate distributions, which are generally taxed as ordinary income in accordance with Sections 301(c)(1) and 316(a) of the Code, regardless of the source of such distributions (i.e., ordinary income, federally tax-exempt interest, or capital gains).[5]

This difference is reflected in a recognized tenet of state taxation—namely that, for purposes of 31 U.S.C. Section 3124(a), the character of certain fund income (in particular, federal obligation interest) passes through to fund shareholders. In this regard, the direct ownership of a federal obligation is not a prerequisite for exempting the income therefrom from state and local taxation. Of the 44 jurisdictions (43 states and the District of Columbia—collectively referred to as "states") that impose some form of personal income tax, every state either statutorily, administratively, or by judicial decision recognizes that federal law prohibits the indirect taxation of income on federal obligations earned through fund distributions.[6] The rationale for this determination

[5] However, if a corporation satisfies the requisite qualifications under Subchapter M of the Code, distributions to shareholders, in certain instances, will retain the same character as the respective income or gains earned at corporate-level. *See*, e.g., Section 852(b)(3) (retaining the character of long-term capital gains), Section 852(b)(5) (retaining the character of income exempt from federal tax under Section 103(a)), and Section 853(a) (retaining the character of foreign source income under Section 861).

[6] *See* Ala. Admin. Code r. 810-2-14.02(4)(b)(2); Ariz. Income Tax Ruling No. 84-10-5; Ark. Dept. Fin. & Admin. Rev. Policy Stmt. 1988-5; Cal. Rev. & Tax Code Section 17145; Col. F.Y.I. Income 20 (Jul. 1992); 1991 Conn. Gen. Stat. Section 12-718; Del. Code Ann. tit. 30, Section 1106(b)(1)(ii); D.C. Code Ann. Section 47-1803.3(b); CCH Georgia State Tax Reporter, Par. 15-450 (1994); Haw. Rev. Stat. Section 235-2.3 (adopting Section 851 and 852 of the Code for state tax purposes); Response to Inquiry No. 1 from CCH, Idaho State Dept. of Revenue and Taxation (Oct. 16, 1989), as quoted from CCH Idaho State Tax Reporter, Par. 10-702.23 (1994); Ill. Inc. Tax Info. Bull. Public. 101, and *Andras v. Illinois Department of Revenue*, 154 Ill. App. 3d

is twofold: (1) 31 U.S.C. Section 3124(a), as amended and interpreted by this Court's holding in *American Bank*, prohibits the direct and indirect taxation of income from federal obligations, *and* (2) the unique tax attributes of funds, which provide fund shareholders with tax treatment comparable to that received by direct investors, requires states to respect the tax-free character of fund

36, 506 N.E.2d 439 (1987), *cert. denied*, 485 U.S. 960 (1988); Ind. Dept. Rev. Info. Bull. No. 79, and *Estate of Kraft v. Indiana Department of State Revenue*, No. C85-789 (Cir.Ct. of Hamilton Co., Ind. (Dec. 2, 1986)); Order of the Director [Iowa] in *In re Everett*, Docket No. 84-215-2C-RC, and *Everett v. Iowa*, 470 N.W.2d 13 (Iowa 1991); K.S.A. 79-32,117(c)(i); 8 Ky. Tax Alerts 10 and 11; La. Rev. Stat. Ann. Section 47:293(6), and instructions to Louisiana Form IT-540 (Resident State Income Tax Return); Md. Admin. Release Nos. 5 and 11, and *Comptroller v. First Union Bank*, 578 A.2d 192 (1990); 36 M.S.A. Section 5121(2)(A); Mass. Gen. L. ch. 62, Section 2(a)(2)(A); Mich. Dept. Treas. Rev. Admin. Bull. 1986-3; Minn. R. 8002.0300 subpart 1(A)(2), and *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); Miss. Reg. 204; Mo. Code Regs. tit. 12, Section 10-2.155(2); Response to Questionnaire from CCH, Montana Department of Revenue, Income Tax Division (Oct., 1989), as quoted from CCH Montana State Tax Reporter, Par. 15-433.47 (1994); Neb. Rev. Stat. Section 77-2716(1)(b); N.H. Info. Release TIR 88-001; N.J.S.A. Section 54A:6-14.1; N.M. Income Tax Reg. Section 2.10; N.Y. Tax Law, Article 22, Section 612(c)(1); N.C. Dept. Rev. Notice (Oct. 4, 1990); N.D. Cert. Code Section 57-38-01.2(1)(c)(6); Ohio State Tax Review, Dept. of Tax., No. 18; Okla. Inc. Tax Rules Section 710:50-15-56(b); Or. Rev. Stat. Section 316.683; 72 Pa. Cons. Stat. Section 7301(f)(II); S.C. Rev. Rul. No. 91-15; Tenn. Code Ann. Section 67-2-104(f); Utah Code Ann. Section 59-10-114(2)(a), and Utah State Tax Comm'n Tax Bull. 15-19; Vt. Formal Ruling 91-7, and *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); Va. Code Ann. Sections 630-2-322, 3(e)(1); W. Va. Emer. Leg. Pers. Inc. Tax Regs., 110 W.Va. Code Regs. 21, Section 12.3.2 (1988), and *Capital Preservation Fund, Inc. v. Department of Revenue*, 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. Ct. App. 1988). *Cf.*, R.I.G.L. Section 44-30-12(c). Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose an individual income tax.

dividends derived from federal obligation interest.[7] For the reasons set forth below, this immunity for mutual fund shareholders from state taxation of federal obligations also should be extended to fund investments in repos, where the underlying assets are federal obligations.

C. Income earned through repurchase agreements and reverse repurchase agreements entered into by mutual funds is also exempt from state taxation if the securities underlying such agreements are federal obligations.

This Court has observed that repos involving federal obligations are crucial to the monetary policy of United States banking operations. *See Federal Open Market Committee v. Merrill*, 443 U.S. 340, 343 (1979). Taxable funds are active participants in the repo markets.[8] Funds operating as open-end investment companies generally use repos to maintain their liquidity to meet re-

[7] Despite the broad prohibition against state taxation of federal obligations, certain states still limit the ability of a fund to pass the character of federal obligation interest through as dividends unless the fund invests a specified minimum percentage (known as a "threshold") of its assets in federal obligations. *See* Cal. Rev. & Tax Code Section 17145(a) (requires at least 50 percent of fund assets at the close of every fiscal quarter in federal obligations); 1991 Conn. Public Acts 3, Section 52(a)(20) (requires at least 50 percent of fund assets at the close of every fiscal quarter in federal obligations); N.J.S.A. Section 54A:6-14.1 (effectively requires at least 80 percent of fund assets to be at all times in certain qualifying assets, including, but not limited to, federal obligations); and N.Y. Tax Law, Article 22, Section 612(c)(1) (requires at least 50 percent of fund assets at the close of every fiscal quarter in federal obligations). Although this case does not involve the constitutionality of the California, Connecticut, New Jersey, and New York statutes, such thresholds would violate 31 U.S.C. Section 3124(a).

[8] For a general analysis of repos and the repo markets, *see Stigum, The Money Market*, 575-630 (1990); *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 566-570, and 584-597 (D.N.J. 1986); and *Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings & Loan Ass'n*, 878 F.2d 742 (3d Cir. 1989).

demption requirements on a timely basis. *See* Section 5(a) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-5(a). Since shareholders of open-end investment companies have the right to redeem their shares on short notice, these funds often find it useful to structure a portion of their investments in federal obligations as repos.

As its name indicates, in a "repurchase agreement" involving federal obligations, a bank or other financial institution agrees to buy a federal obligation and a fund agrees to sell that obligation to the bank or other financial institution at a specified price, subject to an agreement by the fund to repurchase and by the bank or other financial institution to resell that federal obligation or similar federal obligation at a specified date (typically the next business day) for an agreed repurchase price. A "reverse repurchase agreement" usually involves the purchase of federal obligations by a fund from a bank or other financial institution pursuant to an agreement whereby the bank or other financial institution will repurchase that federal obligation or similar federal obligation from the fund at a specified date and price. With these considerations in mind, repos provide funds a convenient method to invest in federal obligations in a relatively short-term risk-free manner.

This case involves the treatment of income generated by funds engaging in reverse repurchase agreements. Specifically, the issue raised is whether such repos, whose underlying assets are federal obligations, should be accorded the protection of 31 U.S.C. Section 3124(a), thereby precluding states from taxing fund income paid as dividends to shareholders. As explained in Part B, this issue is the same as if the federal obligations were held directly by the respondent, in his individual capacity, pursuant to repo transactions.

1. *Reverse repurchase agreements are best viewed as purchase and sale agreements under which the mutual fund directly earns interest on the federal obligations.*

Upon initial examination, repos appear to possess equally balanced characteristics that enable them to be viewed as either secured loans or transactions involving the purchase and sale of their underlying securities.[9] This is best illustrated by diametric characterizations arising under various statutes, administrative pronouncements, and cases. For example, under Section 3(a)(14) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78c(a)(14), the term "sale" includes ". . . any contract to sell or otherwise dispose of." Courts have still characterized repos as secured loans, while characterizing a pledge of repo securities as a sale covered by Section 10(b), 15 U.S.C. Section 78j(b), and Rule 10b-5, 17 C.F.R. Section 229.10b-5, thereunder. *See SEC v. Miller*, 495 F. Supp. 465 (S.D.N.Y. 1980). The better view, however, especially in the context of the overriding interest of preserving the exemption of federal obligations from state taxation, is to treat repos as purchases and sales of the underlying federal obligations. Under this view, the interest on the federal obligations is earned by the fund during the period before it resells the obligations, and the fund's shareholders are entitled to immunity from state taxation of that income.

For example, Section 2(3) of the Securities Act of 1933, 15 U.S.C. Section 77b(3) defines the term "sale" to include "any disposition of a security or interest in a security. . . ." Applying this definition in a transaction akin to a repo, this Court held that a pledge of stock was a sale for purposes of Section 17(a) of the Securities Act of 1933, 15 U.S.C. Section 77q(a). *Rubin v. United States*, 449 U.S. 424 (1981).

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[9] *In re Bevill, Bresler & Schulman Asset Management Corp., supra*, 67 B.R. at 597.

Another example involves the perfection of security interests in federal book-entry obligations under the Uniform Commercial Code ("UCC") as well as applicable federal regulations. It is well recognized that these transactions are treated as purchases and sales of the respective federal obligations.[10] In *In re Legel, Braswell Government Securities Corp.*, 648 F.2d 321 (5th Cir. 1981), a clearing bank involved in a repo transaction delivered securities registered in the name of the seller, indorsed in blank, and stamped "REPO SECURITIES—DO NOT TRANSFER." The court held that the clearing bank was a *bona fide* purchaser of the securities and not considered to have notice of an adverse claim of the seller.[11]

Accordingly, all transfers and pledges of federal obligations to a Federal Reserve Bank or member bank are effected and perfected by a Federal Reserve Bank making an appropriate entry on its records of the securities transferred or pledged. The making of such an entry for the account of a repo participant in the book-entry system has the effect of a "delivery" to the participant as though the federal obligations were in bearer-definitive (i.e., cer-

[10] Ordinarily, purchases and sales of repo securities must comply with the applicable provisions of Article 8 of the UCC. However, most federal obligations involved in repo transactions are now issued in book-entry form. Regulations have been issued by the Department of the Treasury relating to the transfer and perfection of security interests in federal book-entry obligations. *See*, e.g., 31 C.F.R. Section 306.115 *et seq.*; and 31 C.F.R. Section 350.0 *et seq.* Federal regulations preempt the UCC to the extent the UCC provisions are inconsistent with the regulations. *See* UCC Section 9-104(a) and UCC Section 8-321(3). Still, the UCC provisions regarding transfers of title to and security interests in securities are incorporated by reference into the federal book-entry obligation regulations. *See* 31 C.F.R. Section 306.118(b).

[11] In this regard, the UCC provides that a perfected security interest will not prevail over the claims of a *bona fide* purchaser. The UCC defines the term "*bona fide* purchaser" as a purchaser for value, in good faith, and without notice of an adverse claim. UCC Sections 8-302 and 9-309.

tificated) form.[12] Such an entry also makes the pledgee a holder and effects a perfected security interest in favor of the pledgee.[13] In this regard, courts have recognized that the authority governing transactions in federal book-entry securities, where not addressed in 31 C.F.R. Section 306.115, *et seq.* or 31 C.F.R. Section 350.0, *et seq.*, is found in Article 8 of the UCC, involving purchases and sales of securities, not in Article 9 of the UCC, involving secured transactions.[14] Therefore, the principal federal authority governing repo transactions in federal book-entry securities (of the type involved in this case) treats such transactions as purchases and sales of the underlying federal securities.

Recent amendments to the Bankruptcy Code also accord repos "purchase and sale" status. Before the 1984 enactment of Section 559 of the Bankruptcy Code, 11 U.S.C. Section 559, repos were considered secured claims in their underlying assets.[15] Section 559 provides that the

[12] *See, e.g., Wichita Federal Savings & Loan Ass'n v. Comark*, 610 F. Supp. 406 (S.D.N.Y. 1985); *Louisiana State School Lunch Employees Retirement System v. Legel, Braswell Government Securities Corp.*, 699 F.2d 512 (11th Cir. 1983); and *Matthysse v. Securities Processing Services, Inc.*, 444 F. Supp. 1009 (S.D.N.Y. 1979) (constructive possession by a purchaser's broker or purchaser's broker clearing agent constituted constructive possession under UCC Section 8-313(1)).

[13] *See* 31 C.F.R. Sections 306.118(a) and 350.4.

[14] *See In re Lion Capital Group*, 49 B.R. 163, 187 (S.D.N.Y. 1985) (Article 8 of the 1977 version of the UCC applies to federal book-entry securities); *Cosmopolitan Credit and Investment Corp. v. Blyth Eastman Dillon & Co.*, 507 F. Supp. 954 (S.D. Fla. 1981) (Article 9 of the 1972 version of the UCC was not applicable to a repo); and *In re Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404 (8th Cir. 1980) (Article 9 of the 1972 version of the UCC was not applicable to a repo where the court determined that it was not the intention of the parties to create a security interest). *Accord Gilmore v. State Board of Administration*, 382 So. 2d 861 (Fla. App. 1980).

[15] *See In re Lombard-Wall Inc.*, No. 82B 11556, Bankr. S.D.N.Y. (bench decision, Sept. 16, 1982), where repos were considered

exercise of a "contractual right" of a "repo participant" to liquidate a repo will not be stayed, avoided or otherwise limited by any other provision of the Bankruptcy Code. Accordingly, if a counterparty to a repo with a fund, where the underlying securities of the repo are federal obligations, were to file a petition for bankruptcy, the fund would be entitled to liquidate the underlying securities immediately. Therefore, the principal features of Section 559 effectively treat repos as purchases and sales of their underlying securities.[16] *See*, e.g., *In re Bevill, Bresler & Schulman Asset Management Corp.*, *supra*, 67 B.R. at 598, where the court concluded that, for purposes of the Bankruptcy Code, nonpossessory repos still should be treated as purchases and sales of the underlying securities.

In summary, the analysis presented above clearly supports the growing trend of federal statutory and regulatory authorities to treat repos as purchases and sales of the underlying securities. Unlike collateralized loans, the holder of the repo's underlying securities can sell such securities at will, subject only to the legal obligation to redeliver the identical or similar securities at a designated date. Applying this characterization of repos to the fund repo transactions at issue in this case, the fund in which the respondent invested is deemed to have held the underlying federal obligations during the terms of the repo transactions. Therefore, state taxation of interest income attributable to these federal obligations would constitute

secured claims for purposes of applying Section 362(a) of the Bankruptcy Code, 11 U.S.C. Section 362(a). Section 559 was intended to supplant the *Lombard-Wall* decision. *Cf.* Section 362(b)(7), 11 U.S.C. Section 362(b)(7).

[16] There is, however, one attribute of 11 U.S.C. Section 559 that appears to treat repos as secured loans. Section 559 also provides that excess of the proceeds received on the liquidation of securities subject to the repo over the sum of the stated purchase price, any interest thereon, and expenses of the liquidation must be remitted to the bankrupt debtors' estate.

indirect state taxation of federal obligations, and would violate 31 U.S.C. Section 3124(a).

2. ***Even if repurchase agreements and reverse repurchase agreements involving federal obligations are viewed as secured loans, income received by mutual fund shareholders should still be immune from state taxation.***

It is recognized that, under certain circumstances, repos may be treated as secured loans. For example, the Staff of the SEC will not commence enforcement action under Section 12(d)(3) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-12(d)(3), against funds entering into reverse repurchase agreements with broker dealers, provided that the repos are "fully collateralized" during their entire term.[17] In this regard, the SEC concluded that reverse repurchase agreements "fall within the functional meaning of the term 'evidences of indebtedness' for purposes of . . . [the Investment Company Act of 1940]."[18]

Despite its treatment of repos as secured loans under the Investment Company Act of 1940, the SEC still believes that the character and identity of their underlying assets must be considered for certain regulatory purposes. For example, the SEC requires money market funds to treat a repo as an acquisition of the underlying securities where the repo is "collateralized fully."[19] Applying this standard to the repos involved in this case, their under-

[17] *See* Release No. IC-10666, 44 Fed. Reg. 25128 (Apr. 18, 1979). To be "fully collateralized," the SEC requires the value of transferred securities to be at least equal to the value of the "loan" plus accrued interest under the repo. *Id. See also* Release No. IC-17589, 55 Fed. Reg. 30239 (Jul. 25, 1990); and Release No. IC-11958, 46 Fed. Reg. 48637 (Oct. 2, 1981).

[18] Release No. IC-10666, *supra*, at 25129.

[19] *See* Rule 2a-7(c)(4)(i) under the Investment Company Act of 1940, 17 C.F.R. Section 270.2a-7(c)(4)(i); Release No. IC-18005, 56 Fed. Reg. 8113, 8127 (Feb. 27, 1991). However, the SEC re-

lying collateral was federal obligations (specifically United States Treasury Securities). Pet. App. A3. Since Section 2(a)(16) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-2(a)(16), defines the term "government securities" to include ". . . any security issued or guaranteed as to principal and interest by the United States . . . ," repos collateralized by obligations of the United States Treasury should qualify as government securities under the Investment Company Act of 1940. Without regard to whether they are viewed as purchases and sales of the underlying securities or as secured loans, certain funds must look through to the underlying assets of repos in determining their treatment for federal income tax asset diversification purposes under Section 851(b)(4) of the Code, as well as for money market fund diversification purposes of Rule 2a-7 under the Investment Company Act of 1940.[20]

Given the Court's treatment of funds as pass-through entities, the same approach should govern here. *See Burks v. Lasker, supra*, 441 U.S. at 480. As such, fund repo investments should be treated as investments in federal obligations entitled to exemption from state taxation accorded under 31 U.S.C. Section 3124(a).

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cently proposed to amend Rule 2a-7 under the Investment Company Act of 1940 to allow money market funds, under certain conditions, not to treat a fully collateralized repo as an acquisition of the repo's underlying securities. *See* Release No. IC-19959, at 69, 58 Fed. Reg. 68585 (Dec. 28, 1993).

[20] The identical treatment should apply for federal income tax purposes because neither the Code nor the Treasury Regulations under Section 851 of the Code define the meaning of the term "government securities" in determining the asset diversification requirements applicable to regulated investment companies under Section 851(b)(4). Accordingly, Section 851(c)(5) directs that terms relating to Section 851(b)(4), which are not otherwise specifically defined, should have the same meaning as when used in the Investment Company Act of 1940, as amended.

3. *There is no necessary congruence between the federal and state tax treatment of income from repurchase agreements and reverse repurchase agreements.*

Some courts have held that the federal tax exemption contained in Section 103(a) of the Code does not extend to income from repos involving municipal bonds because such repos are equivalent to secured loans.[21] Even assuming that these cases were decided correctly, however, they are not inconsistent with the decision of the Nebraska Supreme Court because it relates to the immunity from *state* taxation of income on federal obligations. The standards governing federal immunity from state taxation are not the same as the standards governing state immunity from federal taxation. The federal immunity, set forth in 31 U.S.C. Section 3124(a), is essentially absolute, except as otherwise specifically provided by federal law. *See*, e.g., *American Bank & Trust Co. v. Dallas County, supra*, 463 U.S. at 864. The state immunity is not as broad. For example, in *South Carolina v. Baker*, 485 U.S. 505 (1988), this Court upheld the federal government's power to tax interest earned on municipal bonds that are not issued in registered form. Therefore, allowing federal taxation of income from repos involving municipal obligations is not incompatible with recognizing that similar income from repos involving federal obligations is immune from state taxation under 31 U.S.C. Section 3124(a).

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[21] *See* Rev. Rul. 74-27, 1974-1 C.B. 24; *First American National Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972); *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); and *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970) (secured loan treatment accorded to repos involving municipal obligations). *But see Citizens National Bank of Waco v. United States*, 551 F.2d 832 (Ct. Cl. 1977) where the court granted purchase and sale treatment where there was no persuasive evidence of the repo counterparty's requirement to resell the underlying securities.

CONCLUSION

The judgment of the Nebraska Supreme Court should be affirmed.

Respectfully submitted,

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JUNE 1994